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In the Supreme Court of the United States

OCTOBER TERM, 1957

No. 897

PELTON STEEL CASTING COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Court of Appeals (Pet. 25-30) is reported at 251 F. 2d 278. The findings of fact and opinion of the Tax Court (I R. 107-162)[1] are reported at 28 T. C. 153.

JURISDICTION

The judgment of the Court of Appeals was entered on January 7, 1958. (Pet. 25, 30.) The petition for a writ of certiorari was filed on April 4, 1958. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

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[1] Record references are to the appendix, Volumes I and II, to petitioner's brief in the Court of Appeals.

QUESTION PRESENTED

Whether, upon the particular facts of this case, the Court of Appeals was correct in affirming the decision of the Tax Court that the taxpayer-corporation in its fiscal year ended November 30, 1946, was, within the meaning of Section 102 of the Internal Revenue Code of 1939, availed of for the purpose of avoiding surtax upon its stockholders by means of permitting earnings and profits to accumulate instead of being divided or distributed.

STATUTES INVOLVED

The pertinent portions of the statutory provisions of Section 102(a) of the Internal Revenue Code of 1939, and of Section 534(a), (b), (c), and (e) of the Internal Revenue Code of 1954, are set forth in the Appendix, *infra*, pp. 12-14.

STATEMENT

The material facts found by the Tax Court (I R. 114-139), and adopted by the court below (Pet. 26), may be summarized as follows:

The taxpayer is a Wisconsin corporation engaged in the manufacture of steel castings. During its fiscal year ended November 30, 1946, and for some time previously, Arthur J. Ehne owned approximately 60 percent of its stock, Thomas L. Fawick 20 percent, and Allen M. Slichter 20 percent. All three men were directors. Ehne was president and treasurer, Fawick was vice-president, and Slichter was secretary. Ehne had general supervision and overall control of taxpayer's operations. Fawick did not take any active part except to attend board meetings and to be available for consultation. Slichter was responsible for sales, employee relations, and works management. (I R. 114-116.)

Taxpayer's sales and profits for the fiscal year ended November 30, 1946, and its status at the close thereof may be summarized as follows (I R. 128, 133):

Net Sales	$1,970,000
Gross Profit on Sales	455,000
Profit Before Taxes	337,000
Net Profit	170,000
Total Cash	590,000
Total Accounts Receivable	118,000
Total Current Assets	814,000
Total Assets	1,393,000
Total Current Liabilities	301,000
Fixed Liabilities	.....
Earned Surplus	921,000

Working capital (excess of current assets over current liabilities) was increasing at $15,000 a month. (I R. 137.) Taxpayer's experience with regard to the collectibility of its accounts receivable was very good, and in fact better than that of the industry as a whole. On November 30, 1946, $117,750.71 of accounts receivable was outstanding, 81.8 percent of which had been billed that November, and a $10,000 reserve for bad debts was deemed adequate. (I R. 127.)

Toward the end of 1945, Ehne, having decided to retire from the business, looked for an opportunity to sell the assets of the taxpayer or his stockholdings therein. Fawick also decided to withdraw, and allied himself with Ehne. Together they controlled 80 percent of the outstanding capital stock. Ehne conducted the negotiations in taxpayer's name as president. Fawick was also active in seeking prospective purchasers. The price asked for the company was $1,500,000. No purchaser was attracted. They made even more vigorous attempts, employing a brokerage firm, in 1946. The price asked remained the same. Their

efforts still failed to produce an outside buyer, at the price asked, in 1946. (I R. 133.)

Slichter did not like the idea of taxpayer's becoming a subsidiary of some out-of-town corporation and of having his employee policies interfered with. (I R. 134.)

In November 1946, Ehne, Fawick, and Slichter, advised by taxpayer's banker and an attorney, agreed upon a plan whereby the taxpayer-corporation would use its own funds to buy up and redeem the combined 80 percent stock interest of Ehne and Fawick at the price they asked, $1,200,000 (80 percent of the $1,500,000 asked for the assets of taxpayer). Under the plan Slichter would be left as the sole controlling stockholder, and Ehne and Fawick would receive $800,000 in cash and $400,000 in preferred stock. The cash would consist of $300,000 of taxpayer's own money and $500,000 to be borrowed for the purpose. An essential aspect of the plan was that taxpayer would not declare a dividend in 1946. To carry out the plan for the purchase of Ehne's and Fawick's interests, a ten-year $500,000 loan, secured by a mortgage on taxpayer's property, was obtained in April 1947 from taxpayer's bank and an insurance company. (I R. 133-137.)

The amount of the personal income tax actually paid by Ehne for 1946 and the estimated amount of tax for which he would have been liable had all of the 1946 earnings and profits ($209,731.58) been distributed in the form of a dividend in that year and had his 60 percent thereof (some $126,000), in addition to his other income for that year ($47,063.93, in accordance with his tax return), been taxed to him at ordinary income rates, are as follows (I R. 138):

Actual	Estimated	Estimated Difference
$22,786.73	$124,955.96	$102,169.23

If the transaction had been carried out by distributing all of the earnings for fiscal year 1946, and reducing the purchase price of Ehne's interest *pro tanto*, Ehne would have paid approximately $102,000 additional tax in 1946 and approximately $119,300 tax on capital gains in 1947 (being one-fourth of $477,571, which represents the sale price of $603,571 less $126,000 of dividends). The total of his tax attributable to the transaction if accomplished as above indicated would have been approximately $221,300 instead of the actual tax attributable thereto paid by him in 1947 in the amount of approximately $150,000 at capital gains rates. (I R. 138.)

The taxpayer was notified pursuant to Section 534 of the Internal Revenue Code of 1954 that the notice of deficiency included an amount with respect to Section 102 of the 1939 Code, relating to surtax on corporations improperly accumulating surplus. In response, the taxpayer submitted a statement of grounds on which it relied to establish that its earnings and profits had not been permitted to accumulate beyond the reasonable needs of the business. (I R. 110-111.)

In its findings of fact, the Tax Court found that taxpayer was availed of during its fiscal year ending November 30, 1946, for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting earnings or profits to accumulate instead of being divided or distributed. It also found that the taxpayer's earnings and profits for the fiscal year 1946 had been accumulated beyond the reasonable needs of its business. (I R. 139.)

In its opinion, the Tax Court concluded that the taxpayer failed to meet its burden of proving that it was not availed of for the purpose of preventing the imposition of surtax upon its shareholders. In view of this conclusion, the court ruled that it was not necessary to resolve the question whether the earnings and profits had been permitted to accumulate beyond the reasonable needs of taxpayer's business. This question, the court held, was the only issue under the provisions of Section 534 as to which the burden of proof could have been shifted to the Commissioner. (I R. 161-162.) However, assuming *arguendo* that the issue were material to its decision and that the burden was shifted to the Commissioner in this respect, the Tax Court further held that the affirmative evidence demonstrates that the Ehne-Fawick deal did not represent a reasonable need of the business, and also that the earnings accumulated in 1946 (even apart from reasonably anticipated future earnings) were materially in excess of any reasonable, planned, or needed future capital expenditures or other reasonably anticipated exigencies or contingencies of the business. (I R. 162.)

The Tax Court accordingly determined a deficiency in Section 102 surtax for the fiscal year ended November 30, 1946, in the amount of $69,746.66. (I R. 162.)

The Court of Appeals unanimously affirmed. (Pet. 25-30.)

ARGUMENT

1. The Tax Court found as a fact that taxpayer had been availed of for the purpose of avoiding surtaxes upon its shareholders through the medium of permitting earnings and profits to accumulate during

its fiscal year ended November 30, 1946, instead of being divided or distributed. (I R. 139.) This finding, affirmed by the Court of Appeals, does not warrant review here. *United States* v. *Gypsum Co.*, 333 U.S. 364, 394-395; *Corn Products Co.* v. *Commissioner*, 350 U.S. 46, 51. In considering the evidence, the courts below correctly applied the pertinent legal criteria as set forth in the statute (Section 102, Internal Revenue Code of 1939, Appendix, *infra*, p. 12) and in the decisions of this Court and the Courts of Appeals. *Helvering* v. *Stock Yards Co.*, 318 U.S. 693; *Helvering* v. *Nat. Grocery Co.*, 304 U.S. 282; *Trico Products Corp.* v. *McGowan*, 169 F. 2d 343 (C.A. 2d), certiorari denied, 335 U.S. 899; *Latchis Theatres of Keene* v. *Commissioner*, 214 F. 2d 834 (C.A. 1st); *McCutchin Drilling Co.* v. *Commissioner*, 143 F. 2d 480 (C.A. 5th); *KOMA, Inc.* v. *Commissioner*, 189 F. 2d 390 (C.A. 10th).

The decisions of the courts below are supported by substantial evidence. By the end of the fiscal year ended November 30, 1946, the taxpayer had an accumulation of earned surplus of $921,000 of which $590,000 was in cash.[2] (I R. 128.) Accounts receivable amounted to approximately $118,000, of which 80 percent was outstanding less than 30 days. (I. R. 127.) The taxpayer had no fixed liabilities and its current assets exceeded current liabilities by $514,000. Working capital was increasing at the rate of $15,000 each month. (I R. 137.) The total assets, pursuant to

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[2] The taxpayer has not raised in its petition for certiorari the point argued below that the accumulated surplus was needed to carry out plans for plant expansion. This contention was rejected by the courts below as being without merit. (I.R. 152, Pet. 27-28.)

audit reports, were $1,393,000. (Ex. 2-B, Supp. R.)[3]

During the year in question, the taxpayer accumulated $209,000 of earnings and profits after paying ordinary income taxes. (I R. 138-139.) None of this amount was distributed as dividends to the three shareholders—Ehne, Fawick, and Slichter. (I R. 133.) By not distributing the earnings and profits, Ehne alone avoided paying $102,000 of individual taxes in 1946. (I R. 138.)[4] Tax avoidance is the only apparent reason, as the Tax Court noted (I R. 146), why taxpayer did not distribute its earnings and profits as dividends and then purchase the Ehne and Fawick stock interests at a price reduced to reflect the value of the remaining assets of taxpayer.[5] By executing the transaction without the distribution of earnings, Ehne alone saved $70,000 of personal taxes on the whole transaction. (I R. 138, 146.) It has been repeatedly held that a court may infer a purpose to avoid taxes from an actual avoidance of taxes to shareholders and the equal availability of alternative transactions which would have had the same result

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[3] "Supp. R." references are to Appendix B of the Commissioner's brief in the Court of Appeals.

[4] The record does not show the amounts of individual income taxes avoided by Fawick and Slichter which must also have been substantial.

[5] Taxpayer states (Pet. 7, 14) that the testimony of its witnesses was that the alternative plan was not financially feasible. As appears from the record, these witnesses were considering the effect of a distribution of earnings on the deal actually consummated, involving a purchase price of $1,200,000 for the stock including $400,000 preferred stock, $300,000 cash, and the $500,000 loan. They were not asked about the practicability of a distribution of 1946 earnings or a loan in the event the price of the stock was to have been reduced proportionately after such a distribution. (I R. 57-58, 64-66, 99-100.)

except that dividends would have been paid and taxed to the shareholders. *Helvering* v. *Stock Yards Co.*, 318 U.S. 693, 701-702; *R. L. Blaffer & Co.* v. *Commissioner*, 103 F. 2d 487 (C. A. 5th), certiorari denied, 308 U.S. 576; *Trico Products Corp.* v. *McGowan*, 169 F. 2d 343, 344-345 (C.A. 2d), certiorari denied, 335 U.S. 899.

No business purpose of the taxpayer-corporation was served by the accumulation of its earnings for the asserted purpose of purchasing the Ehne and Fawick stock. The transaction was beneficial personally to the stockholders, Ehne and Fawick, who were thus able, in selling their stock, to avoid substantial taxes, and to Slichter who became the sole owner. The deal was actually detrimental to the taxpayer whose surplus was depleted by $300,000 and which was required to assume a mortgage of $500,000 in return for no increase of its assets or expansion of its business. The Section 102 tax has been consistently sustained in similar cases where the corporate earnings have been accumulated for the primary personal benefit of stockholders. *Helvering* v. *Nat. Grocery Co.*, 304 U.S. 282; *Helvering* v. *Stock Yards Co.*, 318 U.S. 693; *Beim Co.* v. *Landy*, 113 F. 2d 897 (C.A. 8th); *KOMA, Inc.* v. *Commissioner*, 189 F. 2d 390 (C.A. 10th). The tax is applicable even if only one of several purposes of a transaction was the avoidance of taxes to shareholders. *Trico Products Corp.* v. *Commissioner*, 137 F. 2d 424, 426 (C.A. 2d), certiorari denied, 320 U.S. 799.

2. There is no conflict with the decisions of other Courts of Appeals. *Emeloid Co.* v. *Commissioner*, 189 F. 2d 230 (C.A. 3d), relied on by petitioner (Pet. 8-9), presented an entirely different issue arising under the World War II Excess Profits Tax Act (Second Reve-

nue Act of 1940, c. 757, 54 Stat. 974, Sec. 201 (26 U.S.C. 1940 ed., Secs. 710 *et seq.*)). The question presented in *Enciold* was whether borrowed funds to purchase "key man insurance" were "borrowed invested capital" for the purposes of the excess profits tax statute.*

3. The taxpayer contends (Pet. 22) that the Tax Court improperly applied Section 534 of the 1954 Code, as amended (Appendix, *infra*, p. 13), and placed upon it the burden of proving the reasonableness of its surplus. The Tax Court, however, recognized that the burden of proving the unreasonableness of the surplus was placed on the Commissioner under Section 534, but held that this issue was not material in the circumstances of this case (see *supra*, p. 6). The Tax Court further held that the evidence, even assuming the issue to be material here, demonstrates the unreasonableness of the accumulations. In other words, if the Commissioner was required to meet this burden here, he did so. (I R. 162.)

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*The petitioner also refers (Pet. 10-11) to *Gazette Pub. Co.* v. *Self*, 103 F. Supp. 779 (E.D. Ark.), and *Dill Manufacturing Co.* v. *Commissioner*, 39 B.T.A. 1023. Even if certain language in these unappealed trial court decisions may not be entirely consistent with the decision of the Court of Appeals here, the alleged conflict does not warrant certiorari. Rule 19 (1) (b) of this Court. Particularly is this so since, in large measure, each Section 102 case turns on its own facts.

CONCLUSION

The decision of the court below is correct, there are no conflicting decisions by the Courts of Appeals, and further review is not warranted. Accordingly, it is respectfully submitted that the petition for a writ of certiorari should be denied.

J. LEE RANKIN,
Solicitor General.
CHARLES K. RICE,
Assistant Attorney General.
ROBERT N. ANDERSON,
ELMER J. KELSEY,
Attorneys.

MAY 1958.

APPENDIX

STATUES INVOLVED

Internal Revenue Code of 1939:

SEC. 102. SURTAX ON CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS.

(a) [as amended by Sec. 103(d), Revenue Act of 1941, c. 412, 55 Stat. 687] *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year (in addition to other taxes imposed by this chapter) upon the net income of every corporation (other than a personal holding company as defined in section 501 or a foreign personal holding company as defined in Supplement P) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

27½ per centum of the amount of the undistributed section 102 net income not in excess of $100,000, plus

38½ per centum of the undistributed section 102 net income in excess of $100,000.

* * * * *

(c) *Evidence Determinative of Purpose.*—The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corpo-

ration by the clear preponderance of the evidence shall prove to the contrary.

* * * * *

(26 U.S.C. 1952 ed., Sec. 102.)

Internal Revenue Code of 1954:

SEC. 534. BURDEN OF PROOF.

(a) *General Rule.*—In any proceeding before the Tax Court involving a notice of deficiency based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, the burden of proof with respect to such allegation shall——

(1) if notification has not been sent in accordance with subsection (b), be on the Secretary or his delegate, or

(2) if the taxpayer has submitted the statement described in subsection (c), be on the Secretary or his delegate with respect to the grounds set forth in such statement in accordance with the provisions of such subsection.

(b) [as amended by Sec. 5, Act of August 11, 1955, c. 805, 69 Stat. 669] *Notification by Secretary.*—Before mailing the notice of deficiency referred to in subsection (a), the Secretary or his delegate may send by registered mail a notification informing the taxpayer that the proposed notice of deficiency includes an amount with respect to the accumulated earnings tax imposed by section 531. In the case of a notice of deficiency to which subsection (c) (2) applies and which is mailed on or before the 30th day after the date of the enactment of this sentence, the notification

referred to in the preceding sentence may be mailed at any time on or before such 30th day.

(c) *Statement by Taxpayer.*—Within such time (but not less than 30 days) after the mailing of the notification described in subsection (b) as the Secretary or his delegate may prescribe by regulations, the taxpayer may submit a statement of the grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business.

* * * * * *

(e) [as amended by Sec. 4, Act of August 11, 1955, *supra*] *Application of Section.*—

(1) Notwithstanding any other provision of law, this section shall apply with respect to taxable years to which this subchapter applies and (except as provided in paragraph (2)) to taxable years to which the corresponding provisions of prior revenue laws apply.

(2) In the case of a notice of deficiency for a taxable year to which this subchapter does not apply, this section shall apply only in the case of proceedings tried on the merits after the date of the enactment of this paragraph.

(26 U.S.C. 1952 ed., Supp. V, Sec. 534.)